

STATE OF MONTANA
DEPARTMENT OF LABOR AND INDUSTRY
HEARINGS BUREAU

UNEMPLOYMENT INSURANCE DIVISION,)	Case No. 1529-2007
)	
Complainant,)	
)	
vs.)	FINDINGS OF FACT,
)	CONCLUSIONS OF LAW
VAN HYNING & ASSOCIATES, INC.,)	AND ORDER (FINAL
)	AGENCY DECISION)
Respondent.)	

* * * * *

I. BACKGROUND

The contested case hearing in this matter convened and concluded on September 17, 2007, in the Tax Appeals Room, Cascade County Courthouse Annex, 325 2nd Avenue North, Great Falls, Montana. Complainant Unemployment Insurance Division (UID) attended through its designated representative, Diane Bianchi, with UID’s counsel, Joseph Nevin, Department Legal Services. Respondent Van Hyning & Associates, Inc. (the corporation) attended through its designated representative, Dyrck Van Hyning, with its counsel, Dennis Tighe, Davis, Hatley, Haffeman & Tighe, P.C. The Hearing Officer excluded witnesses, except for the corporation’s expert, Stephen Mehaffey, who, without objection, was allowed to attend the hearing to assist counsel and to be ready to give opinion testimony that included knowledge of the evidence presented at hearing. The Hearing Officer also allowed the attendance of Karen Van Hyning, spouse of Dyrck Van Hyning and the other principal of the corporation, whom the corporation elected to have attend.

Dyrck Van Hyning, Richard (Rick) Eldredge, Diane Bianchi, and Stephen Mehaffey testified under oath at hearing. The Hearing Officer admitted Exhibits 1-8, 100-106, and demonstrative Exhibit A into evidence. Exhibits 1-4 and 100 have been redacted by the corporation’s counsel and the redacted exhibits are part of the public record. The complete copies of those specific exhibits and the sealed portions of the hearing remain sealed under the terms of the existing “Protective Order re Privacy Interests.”

Having considered the evidence adduced, the applicable legal authorities and the arguments of the parties, the Hearing Officer, on behalf of the department, now makes the following findings and conclusions and issues the following order. This is the Department of Labor and Industry’s final agency decision, appealable to the Board of Labor Appeals in accord with the notice at the end of this decision, before the certificate of mailing.

II. FINDINGS OF FACT

1. Van Hyning and Associates, Inc. is a duly registered, active Montana corporation (“the corporation”), incorporated in 1990.

2. The corporation represented to the Unemployment Insurance Division of the Montana Department of Labor and Industry (“UID”) that its principal activity is that of “Candy Broker (sales)” shortly after incorporating.

3. Dyrck Van Hyning and Karen Van Hyning, husband and wife, are the sole shareholders of the corporation, owning 80% and 20% of the outstanding shares, respectively. They are also the sole employees of the corporation. Dyrck Van Hyning is the President of the corporation and Karen Van Hyning is the Secretary-Treasurer.

4. The corporation elected to be taxed as an S Corporation, and for 2005, the corporation reported gross sales of \$87,732.00 on Form 1120S.

5. The 2005 gross sales included receipts from candy/food broker transactions and from transcribing medical reports. The corporation carries no inventory. Brokering sales of candy by the manufacturers or their agents to wholesale buyers and services of transcription, both of which the corporation treated as sales, provided all of the corporation’s reported 2005 incomes.

6. In 2005, the corporation paid its two employees each \$10,040.00, and distributed the \$33,365.00 profit it made after expenses to its two shareholders as dividends, reflected in the corporation’s 1120S as cash advances. The Van Hynings’ 2005 joint tax return listed S Corporation income of \$33,365.00. The amount of the so-called “cash advances” reflected the amount of the profit distributed to the two owners as dividends.

7. On August 3, 2006, UID randomly chose the corporation for an audit for 2005. UID Field Representative Rick Eldredge (Eldredge) interviewed Dyrck Van Hyning and collected data from him about the corporation’s records and business operations for the year 2005.

8. UID apparently had selected distribution of profits to owners who also earned wages for services performed for the corporations they owned as a matter for particular scrutiny. However, UID did not then have, and apparently has still not developed any rule, practice, policy, or procedure regarding factors to evaluate whether owners have received reasonable compensation (wages) for their services, published or otherwise.

9. Eldredge felt that the corporation’s reported wages paid to its two employees were not reasonable compensation for the work performed, given the profit realized by the corporation. Eldredge telephoned Dyrck Van Hyning on September 14, 2006 and told him that he was moving dividends to wages and that the corporation would owe \$31.79 in additional taxes.

10. Eldredge intended to recharacterize the complete amount of the cash advances (dividends) to shareholders in the corporation’s 1120S. He consulted his supervisor, Diane Bianchi. She suggested that although there were no indications that the retirement accounts were qualified, it would be reasonable not to recharacterize cash advances that went into

retirement accounts for Dyrck Van Hyning and Karen Van Hyning as wages. The ad hoc nature of this evaluation and the ultimate determination demonstrates the lack of any coherent, consistent policy or practice, even without publication or other notice to the public, in UID's approach to the reasonable compensation question.

11. Ultimately, Eldredge adjusted Dyrck Van Hyning's wages up \$9,480.04 and Karen Van Hyning's wages down \$1,000.04, deeming the adjustments necessary to establish "reasonable compensation" for the two shareholders' efforts as the two employees of the corporation.

12. On September 18, 2006, Eldredge sent a letter and audit report to the corporation stating that he had adjusted Dyrck Van Hyning's wages up \$9,480.04 and Karen Van Hyning's wages down \$1,000.04. The net increase in wages paid by the corporation that resulted from Eldredge's recharacterization generated an underpayment of Unemployment Insurance taxes of \$16.96, with a penalty of \$3.34, for a total owed in additional taxes and penalties of \$20.30. UID did not provide an explanation of the discrepancy between the amount of taxes owed as orally stated to Dyrck Van Hyning and the amount stated in the report until the contested case proceedings herein.

13. Eldredge stated in his September 18, 2006 letter that payments to corporate officers are exempt from reporting to UID only after reporting "reasonable compensation for services." Eldredge stated that it was his "opinion" that the reported wages were not reasonable.

14. The corporation disputed the audit results and gave timely notice of appeal.

15. Stephen Mehaffey, CPA, Benefit Consulting Group, was retained by the corporation to respond to the results of the UID audit. Mehaffey wrote to UID and asked for studies, analyses, and methodologies that UID used to determine reasonable compensation.

16. UID received Mehaffey's inquiry and responded by writing to Dyrck Van Hyning on October 31, 2006, stating that the audit was based on a reclassification of "cash advances" as wages under Mont. Code Ann. § 39-51-201(23)(a) (definition of wages) and Admin. R. Mont. 24.11.2501(1) ("advances or draws against future earnings, when paid"). The corporation paid profits to the corporate owners as dividends as UID knew or should have known from its audit. Neither owner was paid an advance against future wages from their employment.

17. The corporation used the term "cash advance" to show distributions of profit. The corporation could have used the word "distribution," but either way, the money distributed to the Van Hynings was treated and reported by the corporation and the Van Hynings as dividends.

18. UID wrote to Mehaffey on November 13, 2006, and stated that Eldredge had determined that a reasonable wage for Dyrck Van Hyning was derived from information from the U.S. Department of Labor Bureau of Labor Statistics which shows \$26.90 per hour as the "mean hourly wage" for employees in the "sales representative, wholesale and manufacturing"

category. Eldredge's audit report did not identify the \$26.90 figure or any other any Bureau of Labor Statistics information. UID did not explain how \$26.90 per hour was actually used or was to be used in the future for a calculation of reasonable compensation in other tax years. If the corporation had paid both of its two employees \$26.90 per hour, it would have taken a substantial loss in 2005.

19. The category of "sales representative, wholesale and manufacturing" in Montana includes some of the largest food and candy brokers in the country, such as Sysco which has national sales of more than sixty billion dollars. UID provided no explanation of how hourly wage figures which included wages paid to employees of corporate giants compared to Montana wages in a two-person close corporation.

20. UID wrote to Mehaffey on December 5, 2006, and stated that the department "originally used the National median" for determining a reasonable wage but should have used the state of Montana information which shows a median hourly wage of \$16.72 per hour for the occupation. The \$16.72 figure was not cited in the audit. This third attempt at explaining the audit did not provide any explanation of how \$16.72 per hour had been used or how it was to be used in the future to calculate reasonable compensation. If the corporation had paid \$16.72 per hour to its two employees, it would have lost money in 2005. Neither mean nor median hourly figures were included in the audit as an explanation for Eldredge's opinion. At hearing, UID was unable to state whether it will rely on "median" or "mean" figures in future audits.

21. Mehaffey wrote to UID and stated that he could calculate a range of reasonable compensation for corporate officers or shareholders based on a percentage of sales. Mehaffey's conclusions came from his work with employee benefits and with studies determining businesses' executive compensation, for IRS and SEC reporting purposes. The correlation of wages to sales is standard practice with the IRS. This method takes into account the owners' and shareholders' expectation of a return on their investment as well as the size of the company. Using statistics for executives in the retail confectionary business, Mehaffey found that executive compensation ranges from 11% to 15.8% of sales and confectionary merchant wholesalers range from .6% to 3.6% of sales. His testimony was undisputed that the IRS accepts this methodology of the percentage of gross sales calculation for establishing reasonable compensation for executives such as the Van Hynings.

22. UID did not provide Mehaffey with information from which he could determine how UID calculated reasonable compensation for services. The mean or median figures identified by UID do not provide information from which a business can predict how UID would calculate reasonable compensation for services. Mean or median wage numbers only address industry wide averages within a broad business category and, by definition, recognize that large numbers of wage earners fall below or above the mean or median. Use of the bureau statistics does not take into account business sales, business size, numbers of employees, or small owner/operator business models. Although Mehaffey requested information on how UID figured reasonable compensation, UID did not provide him with any formula or factors that showed how a downward adjustment from the mean or median figures would be applied or whether they would be applied at all.

23. Bianchi testified that UID uses factors to adjust for reasonable compensation for services. The evidence did not show that these factors were based on any concrete data. Any factors actually used were not disclosed in the audit report, were not subsequently disclosed to Mehaffey or the corporation, and were not and apparently still are not written in any published policy or procedure document. How the factors are applied, as well as what the factors actually are, appears unclear and uncertain and subject to arbitrary interpretation based on the opinions of individual auditors and/or their supervisors.

24. Mehaffey's opinion that UID was arbitrary at fixing reasonable compensation for services for Van Hyning is supported by the evidence.

25. Montana's minimum wage law permits employers having gross sales of \$110,000.00 or less to pay wages of \$4.00 per hour to employees. This necessarily is reasonable compensation where it is legal under Montana's minimum wage law. In 2005, the corporation paid its employees at least this amount, since Eldredge's downward adjustment of Karen Van Hyning's wages, in the audit report, resulted in an hourly wage of approximately \$4.35.

26. The corporation would expend between \$3,000.00 and \$5,000.00 in professional fees to amend past tax returns and pay additional payroll taxes and penalties if the recharacterization of dividends as wages in the UID audit stands.

27. UID has not provided a methodology to the corporation for calculating reasonable compensation for services in the future. The lack of a methodology prevents the corporation and every other entity similarly situated from complying with UID's interpretation and application of the law regarding reasonable compensation, because that interpretation and application have not yet been established.

28. The UID determination of 2007 Unemployment Insurance Tax Rates uses the revised 2005 taxable payroll in its determination which has increased payroll taxes for the corporation.

29. UID's determination was arbitrary and capricious.

III. DISCUSSION OF UID'S LEGAL POSITION

The Hearing Officer's Conclusions of Law, *infra*, apply the law to the facts. This discussion is limited to comments regarding UID's legal arguments herein.

Montana law does not define "reasonable compensation for services." The phrase appears twice in department regulations regarding wages, but the provision cited by UID in this proceeding, Admin. R. Mont. 24.11.201(1)(g), does not define the phrase: "[P]ayments distributed to corporate officers or shareholders in lieu of reasonable compensation for services performed, even though designated as profits or dividends [are defined as wages]." If, indeed, the corporation distributed some or all of the dividends paid to the shareholders "in lieu of

reasonable compensation for services performed,” those distributions would be wages. But how is “reasonable compensation for services” defined?¹

The two federal cases UID cited are not helpful. *Spicer Acctng, Inc. v. U.S.* (9th Cir. 1990), 918 F.2d 90, involved a shareholder who performed work for the closely held corporation, received no salary, “donated” his substantial efforts and time to the corporation and took dividends, for the express purpose of avoiding any FICA and FUTA payments. The court determined that because the corporation’s dividend payments to the shareholder were for substantial services rendered, the payments were wages subject to FUTA and FICA. *Radtke v. U.S.* (7th Cir. 1990), 895 F.2d 1196, involved a closely held corporation whose sole director and shareholder was also its sole employee whose annual base salary was “\$ 0” in the year in question, but who received \$18,225.00 in dividends that year from the corporation. The court held that the corporation’s payments to that particular owner, shareholder, and employee during that particular year under the “unusual facts” involved constituted wages, not that all shareholder income from closely held corporations (for services) would necessarily be wages. *Radtke at* 1197-98.

It may well be that Montana would be well served, as a policy matter, by closer scrutiny of dividends paid to working shareholders by closely held corporations. At the very least, UID must adopt and publish something that explains the standards for such scrutiny. It did not, and it has offered no valid explanation for that failure.

IV. CONCLUSIONS OF LAW

1. Mont. Code Ann. § 39-3-409(2) authorized Van Hyning and Associates, Inc. to pay its employees \$4.00 per hour for their services because the corporation’s reported sales were below \$110,000.00 in 2005.

2. The Federal Fair Labor Standards Act exempts from its requirements businesses with gross sales volumes of less than \$500,000.00. 29 U.S.C. §203(s)(1)(A)(ii).

3. The Federal Fair Labor Standards Act does not apply to a family owned business. 29 U.S.C. §203(s)(2).

4. UID has not provided an objective methodology for the determination of “reasonable compensation for services.” UID’s statutes and rules do not define reasonable compensation for unemployment tax purposes. Pursuant to the Montana Administrative Procedure Act and its own governing statutes, UID is required to provide the public with information about how it

¹ The other regulation, Admin. R. Mont. 24.11.2511(4), likewise does not define the phrase. The two statutory references, Mont. Code Ann. §§ 35-8-504(4) and 35-10-401(8), also do not define the phrase. The five references to the phrase in Montana cases are also useless. *Cf. Lynes v. Helm*, 2007 MT 226, 339 Mont. 120, 168 P.3d 651; *Kelly v. Kelly* (1931), 89 Mont. 229, 297 P. 470; *State ex rel. Rankin v. Farmers’ State Bank* (1930), 88 Mont. 233, 292 P. 575; *Forrester v. B&M Consol. Copper & Silver Mining Co.* (1904), 30 Mont. 181, 76 P. 2; *Bank of Commerce v. Fuqua* (1891), 11 Mont. 285, 28 P. 291.

implements or interprets its rules and regulations. Mont. Code Ann. §§ 2-4-102(11)(a) and 39-51-303, see also Admin. R. Mont. 24.11.906. In embarking upon an effort to regulate more closely the payment of reasonable compensation for services by close corporations to their shareholder employees, which may be a suitable regulatory goal, UID must give notice to the public of its adoption, amendment, or implementation of standards of general applicability that implement, interpret, or prescribe law or policy. UID failed to do so in auditing this corporation.

5. Based upon the foregoing conclusions, UID's audit recharacterization of part of the dividends paid by the corporation in 2005 as wages and the accompanying assessments of additional taxes and penalties for that tax year was arbitrary and capricious, denying the taxpayers due process. Mont. Const. 1972, Art. II, Sec. 17.

6. UID erred in its conclusion that for 2005 Van Hying and Associates, Inc. owed \$16.96 for additional 2005 taxes, together with a \$3.34 penalty.

7. UID erred in using its revised 2005 payroll numbers for calculating future unemployment insurance tax rates.

V. ORDER

The audit determination of the Unemployment Insurance Division that a portion of the 2005 dividends paid by Van Hying and Associates, Inc. to its shareholder employee Dyrck Van Hying be recharacterized as wages and that a portion of the 2005 wages paid to its shareholder employee Karen Van Hying be recharacterized as dividends is void *ab initio*. The corporation properly paid its unemployment taxes on its reported 2005 wages. UID is hereby ordered to revise and adjust its records to use the corporation's actual paid wages and actual paid dividends as such, utilizing the actual paid wages for all purposes of 2005 unemployment taxes. Additionally, the UID shall readjust its determination of insurance tax rates for 2007 to reflect the correct 2005 payroll.

DATED this 7th day of February, 2008.

DEPARTMENT OF LABOR & INDUSTRY
HEARINGS BUREAU

By: /s/ TERRY SPEAR
TERRY SPEAR
Hearing Officer

This decision is the final decision of the Montana Department of Labor and Industry in this case. You may appeal this decision to the Board of Labor Appeals within 10 days after this decision was mailed to your last known address. The time for appeal may be extended for good cause. Your appeal must be filed with the Board of Labor Appeals

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